Podcast Script

Episode 7: Bank Resolutions and Receiverships

What This Episode Will Cover	**Diane:** Hello again. My name is Diane Ellis. Welcome to Episode 7 of the FDIC's podcast of *Crisis and Response: An FDIC History, 2008-2013*. In this episode we will discuss bank resolutions and receiverships. In other words, we will describe how the FDIC handled the 489 banks that were closed during the banking crisis.
Introduce Fred and Bret	**Diane:** Joining me today is Bret Edwards, Director of the FDIC's Division of Resolutions and Receiverships. Welcome Bret. **Bret:** Thanks Diane, it's a pleasure to be here. **Diane:** Also with us again today is Fred Carns, Principal Advisor in the FDIC's Division of Insurance and Research. Welcome back, Fred. **Fred:** Thank you Diane.
Background Information	**Diane:** I think it would be helpful for our audience if we start off today by talking about what happens when a bank fails. It doesn't work the way that regular bankruptcy courts work. Bret, can you say something about why it works differently? **Bret:** Sure, banks play an important role in the economy because they provide payment services and loans to consumers and businesses. Under normal

	bankruptcy proceedings, those functions would be disrupted. So instead, when a bank fails, the chartering agent closes the bank and the FDIC is appointed receiver. The FDIC has the authority to act quickly so that, in most cases, banks' customers can continue using their accounts and their checks don't bounce. Receiverships are legal entities that manage the affairs of the failed bank until all of the bank's assets are sold and all claims against the bank are addressed. The FDIC manages and oversees the receivership. **Fred:** We use the term resolution to refer to the initial phase of the receivership. Usually, the FDIC finds another bank that will acquire the whole failed bank or just part of it. If so, then at this point, the FDIC transfers the deposits to the acquiring bank. Most of the time, the acquiring bank buys assets from the failed bank, also, and the FDIC transfers those assets along with deposits to the acquirer on the same day the bank fails. This usually occurs on a Friday, so that the branches can open seamlessly on Monday under new management. It makes for a really busy weekend.
Past Strategy	**Diane:** That's interesting. But let's back up for a minute. There was a banking and thrift crisis in the 1980s and 1990s, and I remember that a whole lot of banks failed back then. The FDIC's experience during that crisis must have affected its decision-making this time around. Bret? **Bret:** Absolutely Diane. And you're correct about a lot of banks failing back then. That crisis ran from 1980 through 1994 and over 1,600 banks failed. **Fred:** Right Bret, and all those failures led to a large volume of failed-bank assets coming under FDIC management. This large amount of assets proved to be expensive and operationally complex to manage.

	Diane: So, our experience last time really did affect our approach during this crisis. **Bret:** Precisely, Diane. Senior staff decided that there were several reasons that quick asset sales were important this time around. First, during the earlier crisis, the FDIC held so many assets that private investors became concerned about how the FDIC might sell them. If the FDIC had sold those assets all at once, then that could have really affected prices. Second, quick sales reduced receivership expenses as well as Corporation staff and operational needs. And finally, it helped the FDIC conserve cash.
Dimensions of the Crisis	**Diane:** Now let's fast forward to 2008. Fred, can you give our listeners a sense of the scope of the recent financial crisis? **Fred:** Well, after ten years of modest bank failure activity and no failures at all from mid-2004 until February 2007, the financial crisis hit. From 2008 through 2013, 489 banks were closed and they held almost $700 billion dollars in assets, which is more than twice the assets held in the 1,600 failed banks of the previous crisis. These 489 banks exclude a couple of huge ones that weren't actually closed because the systemic risk exception was used, as we discussed in a previous podcast episode. The failures cost the FDIC approximately $73 billion dollars during the recent crisis. And as we mentioned in the first podcast, these included two notable failures: IndyMac which became the most costly failure in FDIC history, with approximately $12 billion dollars in losses, and Washington Mutual which was the largest bank failure in FDIC history at $307 billion dollars in assets.

	Bret: The size of the crisis and the speed at which it ramped up proved to be a challenge for the FDIC. By 2009, the second year of the crisis, 2 percent of banks had failed. It took the previous crisis eight years to reach that point.
Franchise Marketing	**Diane:** All right. Now that we have a sense of the scope and speed of the crisis, let’s jump into what happens when a bank fails. A bank failure can really do some harm. The employees are at risk of losing their jobs, uninsured depositors can lose money, and businesses might lose their sources of credit. In small communities, the only bank branch in town might close. If it’s a big bank, the failure could disrupt the entire financial system and the general economy. **Fred:** That’s right. And during the peak of the crisis, we had multiple banks failing every week. This made for a highly charged environment. To reduce the harm to all those people and businesses, the FDIC attempted to resolve banks by seeking an acquirer who would take as many of the bank’s assets and liabilities as possible. Most of the time, the FDIC had at least a few months to plan ahead for the failure. But this all had to happen in secret, because we didn’t want the FDIC’s presence itself to cause any disruption. It was a crisis environment and market participants were skittish. **Bret:** All the more reason to find buyers for the failing banks. The FDIC offers several options to potential acquirers with each option presented with either all deposits or insured deposits only. **Diane:** OK, but just to clarify before we say more about the options, I think we should point out that the FDIC is required by law to consider all bids, including ones that are not among the options offered, and then the FDIC

must accept whichever bid is least costly to the Deposit Insurance Fund, provided it can be implemented. We refer to this as the least-cost test.

The least-cost-test was established in 1992 after a consensus had developed that the FDIC should resolve banks at the least cost to the Deposit Insurance Fund.

We talked about the history of the least-cost-test in two of our earlier podcasts. So Bret, what about those options that were offered during the crisis?

Bret:

Sure Diane. For 78 percent of the bank failures, the FDIC used a "whole bank" transaction, which is exactly what it sounds like: the acquiring bank takes over the deposits and all—or almost all—of the failed bank's assets. One distinctive feature of this crisis was that FDIC relied so heavily on "loss share." This is a type of whole bank transaction where the FDIC agrees to share in losses on the assets purchased according to a contract. The FDIC used loss share for 304 banks, or 62 percent of bank failures during the crisis.

There are other options where the FDIC retains more of the assets in the receivership and sells them later.

Fred:

It wasn't always easy to find acquirers. We had to get really proactive. One way that we expanded the pool of interested and qualified bidders was to look outside the banking industry. The FDIC sold 60 banks to new entrants. They had to be vetted before they could bid—we never wanted to sell a failed bank to someone who wasn't qualified to run it.

Diane:

OK, so it sounds like we achieved our goal to move lots of assets into the private sector right away. And depositors at those banks got immediate access to their funds, too.

But the FDIC sometimes didn't receive any bids that met the least-cost-test, either because no banks offered bids or the bid prices were too low, or the banks failed so quickly that the FDIC couldn't run an effective franchise

	marketing effort. So let's discuss what the FDIC did in those situations. **Fred**: Well, the most common choice at that point was to do a payout. The FDIC paid depositors their insured deposits to meet its insurance obligation, and then sold the failed bank's assets to recover as much of that money as possible. The FDIC did 26 of these during the crisis. **Bret:** Fred, I remember one of those payouts especially well—NOVA bank. It had about $500 million dollars in deposits and it failed right when Hurricane Sandy hit. The hurricane left the bank without electricity, so we had to get creative. We ended up working out of a hotel instead of the bank. **Fred:** And of course the most memorable failure where we didn't have an acquirer upfront was IndyMac. We thought there would be potential acquirers that would offer cost-effective bids, but there was no time to find them because there was a run on deposits. In cases like this, the FDIC has the authority to create a temporary depository institution and then run the franchise marketing effort later. In the case of IndyMac it took nine months before we sold it.
Evolution of Franchise Marketing	**Diane:** OK, so we've talked about several of the options the FDIC might offer to potential acquirers when trying to market the failed banks. Financial markets were definitely changing over the course of the crisis, and so were the FDIC's circumstances. Bret, why don't you talk about how the FDIC's resolution offerings evolved over time, in response to all of those changes? **Bret:** Sure Diane. Early in the crisis, investors exhibited little appetite for risk.

	This created a situation where the FDIC was faced with limited interest in whole bank deals. So in order to attract more bids and improve prices, the FDIC began to use loss sharing more and more. Banks liked this option because it meant they could buy assets but they didn't have to take on all the risk related to the ownership of those assets. The FDIC benefitted as well. It was able to sell more assets right away at better prices. If the markets improved later, the FDIC would pay less to provide the loss sharing coverage. Thankfully, markets did improve, so in many cases, the FDIC's losses on the loss share resolutions were lower than original estimates. **Fred:** Of course, the FDIC didn't know that markets would improve. If they had continued to get worse, the loss share deals probably would have cost even more than the original estimates. That's one reason why the FDIC moved away from offering loss share once market conditions improved.
Receiverships	**Diane:** But resolutions are not the end of the FDIC's process in settling a failed bank's assets, correct? **Bret:** You're right, Diane. If the assets are not assumed by an acquirer in the franchise marketing process, then assets remain in receivership. **Fred:** And because the crisis came on so suddenly, the assets that needed to be sold really ballooned early on. At year-end 2007, the FDIC was managing $800 million dollars of assets in receivership. But just one year later, that number had skyrocketed to $15 billion. **Bret:**

	Again, holding assets in receivership requires asset servicing. For example, retaining loans involves establishing and maintaining customer relations to collect payments, manage escrow accounts, monitor delinquencies, manage and restructure defaulted loans, and approve loan or line of credit disbursements. **Diane:** Well let's talk about the strategies used to sell the assets. The FDIC used a variety of strategies to return assets to the private sector through competitive sales. One method was to sell loans directly. The FDIC sold $11 billion of loans this way, mostly in packages. For real estate properties, the FDIC used brokers and auctions. **Bret:** That's true, Diane. Another strategy was to use securitization. The FDIC securitized about $3 billion in mortgage loans. Because investors were risk averse, the FDIC guaranteed some of the securities to attract investors and improve prices. That meant that the FDIC was at risk if things went badly. **Fred:** Right Bret, and the FDIC used a third strategy for selling its sub-performing and non-performing loans. The FDIC used what is known as a structured transaction sale for many of these assets. In a nutshell, we would set up a separate legal entity called an LLC which stands for Limited Liability Corporation. Then the FDIC would move assets from its receiverships into the LLC. The FDIC would then sell a part of the equity interest to a third party, known as a managing member, and would retain the remainder of the equity interest, thereby keeping some of the risk, too. The FDIC and the managing member would share the proceeds as the assets were managed or sold. The managing member would handle the asset servicing and sales.

	Diane: So, an LLC is more complex than the loan sales, and the FDIC keeps more of the risk, but it has some advantages. The managing member has a strong incentive to maximize collections from the loans because they get more money that way. But that also gives the FDIC more money, too. Is that why the FDIC chose to do LLCs? **Fred:** Exactly. The Resolution Trust Corporation used equity partnerships in the previous crisis for that reason, and they worked out well. **Diane:** So, how many LLCs did the FDIC set up? **Fred:** 35. They held $26 billion dollars in assets. **Diane:** OK, we've talked a lot about how we sell the bank when it fails and how we sell the assets that didn't pass to the acquirer. But Bret, what other responsibilities does the FDIC have as it manages these receiverships? **Bret:** Actually Diane, there are quite a lot of them. The FDIC has to determine who the creditors are, and pay them. Although most of the proceeds go to the FDIC as deposit insurer, the banks owe money to plenty of other creditors as well. The FDIC has to ensure that everyone gets paid according to the creditor rules set in statute. Then there's the asset servicing, which is a huge task. The FDIC also has to handle all the contracts that the bank had signed and a good many lawsuits.

	And the FDIC has to maintain the accounting and taxes, too.
Conclusions	**Diane:** Well that is a lot. Fantastic guys. I think you have laid out some important information here regarding the FDIC's actions in resolving banks and the strategies the FDIC as receiver used. So let's take some time to recap what we discussed today. **Bret:** The recent financial crisis escalated quickly, and bank failures increased rapidly in the early part of the crisis. Given the experience in the previous crisis, the FDIC wanted to return assets to the private sector quickly. **Fred:** Right Bret. And programs where the FDIC shared risk with acquirers, loss share, or with investors, securitization and LLCs proved to be an important strategy for improving prices the FDIC received in a risk-averse environment for failed bank assets.
Closing Remarks	**Diane:** Great. Those sound like important points to remember going forward. Well I hope you have enjoyed the whole series of podcasts. We have been discussing a few highlights from a study on the FDIC's response to the most severe financial crisis since the Great Depression. In the book, we tried to contribute to an understanding of what occurred and also to present some lessons that the FDIC learned from its experience. It begins with a brief description of the origins of the crisis, which triggered a systemic threat that demanded creative responses from the FDIC and other financial regulators. It then discusses the actions taken by the FDIC and other federal regulators to address the systemic threat. It also examines how the FDIC managed its insurance fund, supervised banks, and resolved the banks

	that failed. We're all glad that the crisis is behind us, and that the banking industry is now in a position of strength. But this should not be a cause for complacency. The crisis showed how quickly and unexpectedly conditions can change. It is important to remember the lessons we learned during the crisis and remain vigilant in the years ahead. On behalf of Fred Carns and Bret Edwards, this is Diane Ellis, thanking you for joining us for our final episode of the FDIC's *Crisis and Response* podcast. For more information on any of the topics we've discussed, remember that *Crisis and Response* is available on the FDIC's website.